Milagro
ENERGY INC

2005 ANNUAL REPORT

# Balancing Business Growth

Judy Creek Oil Battery
under construction

Milagro is an exploration and production company engaged in the acquisition, exploration, development and production of oil and natural gas reserves in western Canada. Our strategy is to use a balanced risk approach to building a company with properties that provide a base of reserves and production, an opportunity for growth and the potential for high impact exploration. The company is listed for trading on the Toronto Stock Exchange under the symbol MIG.


OPERATING AND FINANCIAL HIGHLIGHTS **1**

LETTER TO SHAREHOLDERS **2**

MANAGEMENT'S DISCUSSION AND ANALYSIS **5**

FINANCIAL STATEMENTS AND NOTES **19**


## Risk

**We tend to celebrate risk only after it has led to great things, which means we rarely celebrate the risk-takers who haven't yet been rewarded for their efforts. The paradox is that we are often unwilling to embrace ambition until it's safe to do so.**

## OPERATING AND FINANCIAL HIGHLIGHTS

| | **2005** | 2004 | 2003 |
|---|---|---|---|
| **FINANCIAL** (000's except per share data) | | | |
| Oil and gas revenue [3] | **$ 8,361** | $ 9,205 | $ 8,277 |
| Cash flow from operations | **$ 2,670** | $ 3,564 | $ 3,095 |
| Per share – diluted | **$ 0.05** | $ 0.07 | $ 0.10 |
| Net earnings (loss) [2] | **$ (103)** | $ (2,499) | $ 502 |
| Per share – diluted | **$ (0.00)** | $ (0.06) | $ 0.02 |
| Capital expenditures (net) | **$ 16,577** | $ 9,960 | $ 18,491 |
| Debt and working capital | **$ 12,901** | $ 5,702 | $ 2,879 |
| Shareholders' equity [2] | **$ 30,075** | $ 24,280 | $ 23,026 |
| Total assets [2] | **$ 49,375** | $ 34,152 | $ 31,897 |
| **OPERATING** | | | |
| Average daily production | | | |
| Oil & NGLs (bbls per day) | **340** | 461 | 292 |
| Natural gas (mcf per day) | **834** | 1,334 | 2,161 |
| Equivalent barrels (BOE [1] per day) | **479** | 684 | 652 |
| **SHARE DATA** | | | |
| Number (thousands) | | | |
| Outstanding at period end | **53,531** | 47,780 | 41,465 |
| Fully diluted at period end | **54,863** | 49,458 | 42,969 |
| Trading price ($ per share) | | | |
| High | **1.57** | 1.20 | 1.55 |
| Low | **0.55** | 0.36 | 0.62 |
| Close | **0.65** | 1.05 | 1.17 |
| Shares traded (thousands) | **61,938** | 49,490 | 15,682 |

(1) BOE means "barrel of oil equivalent" converting six mcf of natural gas to one barrel of oil (6:1).

(2) Certain amounts have been restated to reflect the retroactive application of adopting CICA handbook Section 3110, "Asset Retirement Obligations", in 2003.

(3) In 2004 Milagro adopted the amendment to CICA Handbook Section 1100 Generally Accepted Accounting Principles whereby transportation costs are presented as an expense in the Statement of Operations and Retained Earnings. Prior to 2004, transportation costs were recorded as a reduction in revenue. Prior year comparatives have been restated to reflect this change in accounting policy.

## LETTER TO SHAREHOLDERS

Milagro ended 2005 as a very different company than it was one year before. During 2005, Milagro transformed its focus from developing shallow gas and oil in S.W. Saskatchewan at Battle Creek to making exploration discoveries at Judy Creek in West Central Alberta. Milagro's capital expenditure program also reflected this transformation as the company spent 97 percent of the total $22.2 million capital budget, including the Tri-Seven acquisition, in Alberta. Milagro was targeting and was successful in discovering growth in reserves as demonstrated by a 79 percent increase in the total proven plus probable reserves to 4.7 MMBOE, for the year ending December 31, 2005.

With limited spending on our mature producing base, Milagro saw declines in our production while the company focused its capital expenditure program on Judy Creek exploration. The exploration drilling at Judy Creek in West Central Alberta has resulted in new reserves and numerous development opportunities. Milagro is completing construction of an oil battery complete with gas handling and compression facilities at Judy Creek scheduled to be operational by the end of March which will increase operating efficiencies. These efforts are designed to create an organization with both a stable base of production and substantial organic growth opportunities.

Milagro balances business risk through strategic acquisitions and divestitures while maintaining and building a large inventory of drilling opportunities. We now have an undeveloped land position approaching 80,000 net undeveloped acres, that will facilitate both near and long term growth. Our recent accomplishments included:

- Acquired Tri-Seven Resources Ltd. and other assets at Judy Creek for $3 million. This added approximately 60 BOE but strategically gave Milagro a 60 percent operated interest in the Judy Creek Gas Plant.
- Closed the acquisition of Chirripo Resources Inc. for approximately $13.2 million on March 7, 2006 which provides access into the Peace River arch area for near term production adds and increases our prospect inventory in this desirable area.
- Drilled nine exploration wells with an 89 percent success rate. Initiated developing our large reserve potential prospects at the Judy Creek area, where we have assembled a dominant land and infrastructure position.

## Production

Milagro has been successfully building a solid base of production at Judy Creek where we set out to discover new long life reserves of high quality oil in a multizoned area. After drilling nine wells to date with an 89 percent success rate we have established four play types to date on our land:

The Gilwood zone: the original prospect at Judy Creek is based on the Gilwood zone which has been overshadowed by success in the Swan Hills and Pekisko zones. The Gilwood has been found in a number of new wells but has yet to be completed until commingling is approved. The basic play has not changed in that we believe that the majority of our lands are hydrocarbon saturated and with drilling we may find better porosity and permeability. The wells drilled to date, with the Gilwood zone present, show low deliverability but should have long life reserves. As we drill more wells developing the Swan Hills platform play we will further explore and evaluate the Gilwood potential of Milagro's land block;

The Swan Hills platform zone: has production characterized by low deliverability with large reserves and is the producing zone in the majority of the deeper wells producing at Judy Creek. The reserve potential of this play is large and with the Gilwood zone commingled should provide good economic returns;

The Swan Hills reef zone: Milagro has the potential for up to four locations on its lands in the Judy Creek Beaverhill Lake "A" pool and plans to drill a well in 2006 testing this play. The Swan Hills reef zone characteristics are good deliverability with large reserves;

The Pekisko zone: production is medium quality oil & associated gas whose economics may be enhanced with blending opportunities with our higher quality Gilwood and Swan Hill's oil. The Pekisko zone has average deliverability with medium to longer life reserves that are trapped in a subcrop and outlier type plays across the northern portion of our land block.

## Reserves

We have demonstrated year over year growth in proven plus probable reserves. Milagro ended the year with 4.686 MMBOE of proven plus probable reserves and 9.310 MMBOE of proven plus probable plus possible reserves (evaluated in accordance with NI 51-101) which speak to the upside of the Judy Creek play.

## Capital Expenditure Funding

Milagro's $22.2 million capital budget was funded 33 percent through the issuance of new equity, 37 percent from cash flow from operations and proceeds from dispositions of non-engineered assets and 30 percent from working capital.

## Outlook

In 2006, Milagro plans to concentrate on the development of the oil and associated gas discoveries on our large contiguous land base at Judy Creek and further capitalize on some re-completions, tie-ins and new drilling on the recent corporate acquisition of Chirripo Resources Inc. 2005 activities have expanded our prospect drilling inventory to 60 locations 67 percent of which are targeting light oil. The company also plans to pipeline connect two currently shut-in Judy Creek wells along with the new drilling in 2006 which includes a Pekisko horizontal well and a Swan Hills reef location in the Judy Creek Beaverhill Lake "A" pool.

Milagro has value currently not included in the reserve report as a result of its Nitrogen resource which was tested earlier in 2005 at Battle Creek. The company had the resource evaluated by AJM Petroleum Consultants effective as of December 31, 2005 in accordance with NI 51-101, the results were 22.1 billion cubic feet of gas in place for total proved undeveloped; 31.2 billion cubic feet of gas in place for total proved plus probable; and 52.1 billion cubic feet of gas in place for total proved plus probable plus possible.

On behalf of the Board and the management team, we extend our appreciation to our employees for all their efforts. To our shareholders, we thank you for your continued support.

On behalf of the Board of Directors,

Jeffrey C. Rekunyk
President & CEO
March 8, 2006

# Management's Discussion and Analysis

This management's discussion and analysis ("MD&A") should be read in conjunction with Milagro's audited financial statements for the years ended December 31, 2005 and 2004, together with the accompanying notes.

This MD&A contains forward-looking statements. Forward-looking statements are based on current expectations that involve a number of risks and uncertainties which could cause actual events or results to differ materially from those reflected in the MD&A. Forward-looking statements are based on the estimates and opinions of Milagro's management at the time the statements were made.

Per barrel of oil equivalent ("BOE") amounts have been calculated using a conversion rate of six thousand cubic feet of natural gas to one barrel of oil ("6:1"). The 6:1 conversion ratio is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead. BOE disclosure may be misleading, particularly if used in isolation. Readers should be aware that historical results are not necessarily indicative of future performance.

The MD&A contains the term cash flow from operations, which should not be considered an alternative to, or more meaningful than, cash flow from operating activities as determined in accordance with Canadian generally accepted accounting principles as an indicator of the Company's performance. Milagro's calculation of cash flow from operations may not be comparable to that reported by other companies. Cash flow from operations per share is calculated using the same weighted average number of shares outstanding used in the calculation of earnings per share.

## SELECTED ANNUAL INFORMATION

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| **Financial** (000's except per share data) | | | |
| Oil and gas revenue | 8,361 | 9,205 | 8,277 |
| Cash flow from operations | 2,670 | 3,564 | 3,095 |
| Per share – basic | 0.05 | 0.07 | 0.11 |
| Per share – diluted | 0.05 | 0.07 | 0.10 |
| Net earnings (loss) | (103) | (2,499) | 502 |
| Per share – basic | (0.00) | (0.06) | 0.02 |
| Per share – diluted | (0.00) | (0.06) | 0.02 |
| Capital expenditures (net) | 16,577 | 9,960 | 18,491 |
| Debt and negative working capital | 12,901 | 5,702 | 2,879 |
| Shareholders' equity | 30,075 | 24,280 | 23,026 |
| Total assets | 49,375 | 34,152 | 31,897 |
| **Operating** | | | |
| Average daily production | | | |
| Oil and NGL's (bbls/day) | 340 | 461 | 292 |
| Natural gas (mcf/day) | 834 | 1,334 | 2,161 |
| Equivalent barrels (BOE/day) | 479 | 684 | 652 |
| **Wells drilled** | | | |
| Gross | 9 | 8 | 18 |
| Net | 9.0 | 8.0 | 18.0 |
| **Undeveloped land** | | | |
| Net acres | 49,296 | 50,520 | 47,100 |
| **Common Share Information** | | | |
| Shares outstanding (000s) | | | |
| Weighted average during the period | 50,530 | 44,672 | 40,366 |
| Period end – basic | 53,531 | 47,780 | 41,465 |
| Period end – diluted | 54,863 | 49,458 | 42,969 |

## 2005 OVERVIEW

Milagro's $20.1 million capital expenditure program, not including the corporate acquisition of Tri-Seven, was allocated to the following areas: Saskatchewan – $0.5 million; Alberta – $19.4 million; and corporate $0.2 million. Notable expenditures included the drilling of 9 wells at Judy Creek. Capital expenditures were funded 37 percent through the issuance of new equity, 41 percent from cash flow from operations and proceeds from dispositions and 22 percent from working capital.

During 2005 Milagro issued a total of $7.2 million of new equity. In July, 1.1 million CDE flow-through common shares were issued at $1.44 per share, 2 million CEE flow-through common shares at $1.50 per share and 2.1 million common shares at $1.19 per share.

Average daily production in 2005 was 479 BOE per day, 29 percent natural gas and 71 percent oil and NGLs.

Milagro completed 2005 with a December 31, 2005 net debt of $12.8 million which is 4.7 times the trailing cash flow from operations.

## DETAILED FINANCIAL ANALYSIS

### Production

| | Three months Ended Dec. 31 | | | Year Ended Dec. 31 | | |
|---|---|---|---|---|---|---|
| | **2005** | 2004 | % Change | **2005** | 2004 | % Change |
| Oil and NGLs (bbls/day) | **339** | 427 | (21) | **340** | 461 | (26) |
| Natural gas (mcf/day) | **828** | 1,044 | (21) | **834** | 1,334 | (37) |
| BOE (BOE/day) | **477** | 601 | (21) | **479** | 684 | (30) |

Production for the three months ended December 31, 2005 averaged 477 BOE per day, 21 percent lower than the same period in 2004. Oil and NGLs production decreased 21 percent to 339 barrels per day while natural gas production declined 21 percent to 828 mcf per day. Fourth quarter 2005 oil production is lower due to natural declines at Milagro's Battle Creek and Bittern Lake properties. The Judy Creek property still has oil production behind pipe waiting on the Judy Creek oil battery to be installed. The comparative decline in fourth quarter natural gas production is due to natural gas declines at the Battle Creek property. During the fourth quarter of 2005, Milagro produced 222 barrels of oil per day in Saskatchewan and 117 barrels of oil and NGLs per day in Alberta. Fourth quarter natural gas production was 419 mcf per day in Saskatchewan and 409 mcf per day in Alberta.

Production for the year ended December 31, 2005 averaged 479 BOE per day, a 30 percent decrease compared to last year. Oil and NGL production decreased 26 percent to 340 barrels per day and natural gas production decreased 37 percent to 834 mcf per day. Lower oil production is primarily the result of declines at the Battle Creek property. The year-over-year decrease in natural gas production is a result of declines at the Battle Creek property.

## Selling Prices

### Milagro Field Prices

| | Three Months Ended Dec. 31, | | | Year Ended Dec. 31, | | |
|---|---|---|---|---|---|---|
| | **2005** | 2004 | % Change | **2005** | 2004 | % Change |
| Oil and NGLs ($/bbl) | **49.05** | 34.78 | 41 | **46.25** | 35.90 | 29 |
| Natural gas ($/mcf) | **11.23** | 6.45 | 74 | **8.62** | 6.44 | 34 |
| BOE ($/BOE) | **54.34** | 35.91 | 51 | **47.84** | 36.78 | 30 |

### Benchmark Prices

| | Three Months Ended Dec. 31, | | | Year Ended Dec. 31, | | |
|---|---|---|---|---|---|---|
| | **2005** | 2004 | % Change | **2005** | 2004 | % Change |
| Oil – Edmonton Light ($/bbl) | **71.17** | 57.72 | 23 | **68.72** | 52.55 | 31 |
| Gas – AECO–C spot ($/mcf) | **11.43** | 6.53 | 75 | **8.76** | 6.56 | 34 |

Fourth quarter 2005 oil and NGL selling prices averaged $49.05 per barrel, up 41 percent from prices received during the last quarter of 2004. Realized natural gas prices were $11.23 per mcf in 2005, up 74 percent from prices received during the same period last year. Throughout 2005 and 2004, Milagro sold all of its oil production at spot prices.

Milagro's 2005 realized selling prices were $46.25 per barrel of oil and NGL and $8.62 per mcf of natural gas.

## Revenue

| | Three Months Ended Dec. 31, | | | Year Ended Dec. 31, | | |
|---|---|---|---|---|---|---|
| ($000s) | **2005** | 2004 | % Change | **2005** | 2004 | % Change |
| Oil and NGLs | **1,541** | 1,368 | 13 | **5,737** | 6,063 | (5) |
| Natural gas | **845** | 619 | 37 | **2,624** | 3,142 | (16) |
| Total | **2,386** | 1,987 | 20 | **8,361** | 9,205 | (9) |

Comparing the last quarter of 2005 to the same period in 2004, revenue increased 20 percent to $2,386,000.

On an annual comparison the revenue declined 9 percent to $8,361,000 due to lower production volumes which was partially offset by higher prices.

## Royalties

| | Three Months Ended Dec. 31, | | | Year Ended Dec. 31, | | |
|---|---|---|---|---|---|---|
| ($000s) | **2005** | 2004 | % Change | **2005** | 2004 | % Change |
| Crown | **214** | 173 | 24 | **767** | 1,220 | (37) |
| Overriding and freehold | **73** | 78 | (6) | **322** | 432 | (25) |
| Total | **287** | 251 | 14 | **1,089** | 1,652 | (34) |
| Royalty rate (% of revenue) | **12%** | 13% | (8) | **13%** | 18% | (28) |
| $/BOE | **6.53** | 4.54 | 44 | **6.23** | 6.60 | (6) |

Royalties in the three months ended December 31, 2005 were $287,000 which is 14 percent higher than the $251,000 recorded in the last quarter of 2004. On a quarterly comparison, fourth quarter 2005 Alberta crown royalties were larger than the royalty reduction from declining production at Saskatchewan. On an annual basis, 2005 royalties were $1,089,000 down 34 percent compared to 2004. The year-over-year decrease is primarily due to a reduction in the production levels.

### Production Expenses

| | Three Months Ended Dec. 31, | | | Year Ended Dec. 31, | | |
|---|---|---|---|---|---|---|
| | **2005** | 2004 | % Change | **2005** | 2004 | % Change |
| Oil and NGLs ($/bbl) | **22.55** | 9.79 | 130 | **17.82** | 7.81 | 128 |
| Natural gas ($/mcf) | **6.57** | 2.33 | 182 | **3.44** | 1.79 | 92 |
| BOE ($/BOE) | **27.43** | 11.01 | 149 | **18.64** | 8.76 | 113 |

Production expenses increased 98 percent to $1,204,000 in the fourth quarter of 2005 from $609,000 in the fourth quarter of 2004. On a unit basis, oil and NGL expenses increased 130 percent to $22.55 per barrel and natural gas expenses increased 182 percent to $6.57 per mcf. A portion of the fourth quarter 2005 oil and NGL expenses are non-recurring and relate to number of workovers and repairs in Saskatchewan. Natural gas expenses are higher as a result of new Alberta production startup non-recurring expenditures.

On a year-over-year basis, production expenses increased 49 percent to $3,258,000 from $2,193,000 in 2004. Production costs per BOE increased in 2005 due to Battle Creek work-overs, Bittern Lake electrification and work-overs, and Judy Creek startup expenditures.

### Field Netbacks

| | Three Months Ended Dec. 31, | | | Year Ended Dec. 31, | | |
|---|---|---|---|---|---|---|
| | **2005** | 2004 | % Change | **2005** | 2004 | % Change |
| Oil and NGLs ($/bbl) | **16.66** | 18.35 | (9) | **19.37** | 18.55 | 4 |
| Natural gas ($/mcf) | **3.85** | 3.32 | 16 | **4.33** | 3.66 | 18 |
| BOE ($/BOE) | **18.51** | 18.79 | (1) | **21.30** | 19.65 | 8 |

Fourth quarter 2005 field netbacks were $18.51 per BOE, broken down as to $16.66 per barrel of oil and NGL and $3.85 per mcf of natural gas. Compared to the fourth quarter of 2004, oil and NGL netbacks decreased 9 percent largely due to higher production expenses being spread out over lower production volumes. Natural gas netbacks increased 16 percent, due to higher selling prices and lower royalties.

Field netbacks for the year ended December 31, 2005 were $21.30 per BOE, broken down as to $19.37 per barrel of oil and NGL and $4.33 per mcf of natural gas. On a year-over-year basis, Oil and NGL netbacks increased 4 percent due to increases in revenue. As well, natural gas netbacks increased 18 percent primarily due to higher revenue.

## General and Administrative Expenses

| ($000s) | Three Months Ended Dec. 31, 2005 | 2004 | % Change | Year Ended Dec. 31, 2005 | 2004 | % Change |
|---|---|---|---|---|---|---|
| Total | **476** | 360 | 32 | **1,270** | 1,358 | (6) |
| Overhead recoveries | **(153)** | (82) | 87 | **(389)** | (294) | 32 |
| Capitalized | **(31)** | (33) | (6) | **(125)** | (125) | – |
| Expensed | **292** | 245 | 19 | **756** | 939 | (19) |
| Expensed per BOE ($/BOE) | **6.65** | 4.43 | 50 | **4.32** | 3.75 | 15 |

Compared to the same period last year, fourth quarter 2005 total general and administrative ("G&A") costs increased 32 percent to $476,000.

For the year ended December 31, 2005, total G&A costs were $1,270,000, down 6 percent from the previous year. The 32 percent increase in overhead recoveries is the result of increased spending on the capital expenditure program. All of Milagro's capital projects, production facilities and producing wells are charged an industry accepted overhead charge that reduces corporate G&A costs expensed. During 2005, Milagro managed all of its capital projects and operated all of its wells, and capitalized $125,000 of related salaries to oil and gas properties.

## Financing Charges

Financing charges were $74,597 during the fourth quarter of 2005 as a result of increased long term debt levels in comparison to the fourth quarter 2004. Of this total, $35,000 is for commitment fees paid relating to the establishment of a new loan facility.

Financing charges for the year ended December 31, 2005 were $134,522, down 29 percent from amounts incurred in 2004. In 2005, Milagro did not use its revolving line of credit to the levels used in 2004. This resulted in lower interest and standby fee during the period. On a unit basis, 2005 financing charges were $0.77 per BOE, up 1 percent from $0.76 per BOE in 2004.

## Depletion, Depreciation and Accretion

| ($000s) | Three Months Ended Dec. 31, 2005 | 2004 | % Change | Year Ended Dec. 31, 2005 | 2004 | % Change |
|---|---|---|---|---|---|---|
| Depletion and depreciation of oil and gas properties | **1,209** | 3,695 | (67) | **3,464** | 6,988 | (50) |
| Accretion of asset retirement obligations | **23** | 21 | 10 | **92** | 84 | 10 |
| Depreciation of office equipment | **6** | 6 | – | **24** | 24 | – |
| Total | **1,238** | 3,722 | (67) | **3,580** | 7,096 | (50) |

| ($/BOE) | Three Months Ended Dec. 31, 2005 | 2004 | % Change | Year Ended Dec. 31, 2005 | 2004 | % Change |
|---|---|---|---|---|---|---|
| Depletion and depreciation of oil and gas properties | **27.54** | 66.81 | (59) | **19.81** | 27.92 | (29) |
| Accretion of asset retirement obligations | **0.52** | 0.38 | 37 | **0.53** | 0.34 | 56 |
| Depreciation of office equipment | **0.14** | 0.11 | 27 | **0.14** | 0.10 | 40 |
| Total | **28.20** | 67.30 | (58) | **20.48** | 28.36 | (28) |

The provision for depletion, depreciation and accretion expense ("DD&A expense") is comprised of three components: depletion and depreciation of oil and gas properties; accretion of asset retirement obligations; and depreciation of office equipment. Depletion and depreciation of oil and gas properties is computed using the unit-of-production method based on proved reserves estimated at the end of the period. Accretion of asset retirement obligations is computed by applying a credit-adjusted risk-free interest rate to the beginning of the period liability balance.

For the year ended December 31, 2005, DD&A expense was $3,580,000, a 50 percent decrease from the amount recorded in 2004. In 2004 the Company incurred a ceiling test write down of $2,600,000. The reduced book values contributed to reducing the depletion expense booked for 2005. The decrease in depletion and depreciation unit rates used can be attributed to the maintenance of company reserves from the addition of new reserves at Judy Creek.

### Stock-based Compensation

The 2005 and 2004 financial statements include stock-based compensation expense for all stock options granted after December 31, 2002 and for stock options granted prior to January 1, 2003 to consultants.

In 2005, Milagro recorded stock-based compensation expense of $129,700, up from $38,300 in 2004. The 2005 increase occurred due to the number of new stock options granted in the fourth quarter of 2004 and additional grants in 2005.

### Taxes

Cash taxes for 2005 totaling $162,000 relate entirely to the Saskatchewan Resource Surcharge and Capital Tax. Saskatchewan Resource Surcharge and Capital Tax is calculated as a percentage of the corporation's Saskatchewan based production revenues adjusted to approximate well head prices. Milagro did not incur current income taxes in 2005 and did not pay current income taxes in 2004.

For the year ended December 31, 2005, Milagro recorded a future income tax recovery of $936,000 of which a significant portion is a result of the tax treatment of the gain on the sale of the $CO_2$ asset as a capital gain which is subject to tax on 50 percent of the gain.

At the end of 2005, Milagro had estimated income tax deductions of approximately $31 million available to reduce future taxable income. The table below summarizes these deductions by category. The final balances may be revised as a result of a change in filing position or an audit and reassessment by Canada Revenue Agency. Any revision is not expected to be material to Milagro's overall income tax horizon.

| | Available Balance | Deduction Rate |
|---|---|---|
| Canadian exploration expense | $ 3,990,000 | 100% |
| Canadian development expense | 10,752,000 | 30% |
| Canadian oil and gas property expense | 1,329,000 | 10% |
| Undepreciated capital cost | 13,628,000 | 25% |
| Other | 948,000 | straight line over 5 years |
| Total | $30,647,000 | |

### Cash Flow From Operations

Basic cash flow from operations was $408,000 ($0.01 per share) in the fourth quarter of 2005 as compared to $693,000 ($0.01 per share) during the same period last year. The decrease in cash flow is the result of lower production.

For the year ended December 31, 2005, basic cash flow from operations was $2,670,000 ($0.05 per share) as compared to $3,564,000 ($0.07 per share) in 2004.

### Corporate Cash Netbacks

| ($ per BOE) | Three Months Ended Dec. 31, 2005 | 2004 | % Change | Year Ended Dec. 31, 2005 | 2004 | % Change |
|---|---|---|---|---|---|---|
| Field netbacks | **18.51** | 18.79 | (1) | **21.30** | 19.65 | 8 |
| General and admin. expenses | **(6.65)** | (4.43) | 50 | **(4.32)** | (3.75) | 15 |
| Financing charges | **(1.70)** | (0.84) | 102 | **(0.77)** | (0.76) | 1 |
| Current taxes | **(0.87)** | (0.99) | (12) | **(0.93)** | (0.90) | 3 |
| Cash flow from operations | **9.29** | 12.53 | (26) | **15.28** | 14.24 | 7 |

### Net Earnings (Loss)

Milagro recorded a loss of $431,000 in the fourth quarter of 2005 as compared to a loss of $2,029,000 for the same period in 2004. The 2005 loss from operations was due to a combination of decreased production volumes and increased production expenses.

For the year ended December 31, 2005, Milagro recorded a net loss of $103,000 ($0.00 per share – diluted), down from a net loss of $2,499,000 ($0.06 per share – diluted) in 2004.

### Capital Expenditures

| (000s) | Three Months Ended Dec. 31, 2005 | 2004 | % Change | Year Ended Dec. 31, 2005 | 2004 | % Change |
|---|---|---|---|---|---|---|
| Land acquisition and retention | **1,059** | 4 | 26,375 | **1,246** | 183 | 581 |
| Geological and geophysical | **13** | 0 | n/a | **534** | 57 | 837 |
| Drilling and completions | **5,889** | 2,819 | 109 | **12,455** | 6,192 | 101 |
| Production equipment and facilities | **3,441** | 589 | 484 | **5,734** | 3,565 | 61 |
| Property acquisitions | **–** | – | – | **–** | – | – |
| Capitalized overhead | **31** | 33 | (6) | **125** | 125 | – |
| Office | **–** | (1) | (100) | **2** | 3 | (50) |
| Total expenditures | **10,433** | 3,444 | 203 | **20,096** | 10,125 | 98 |
| Dispositions | **–** | (165) | (100) | **(5,580)** | (165) | 3,282 |
| Net expenditures | **10,433** | 3,279 | 218 | **14,516** | 9,960 | 46 |

Milagro's 2005 capital expenditures were $20,096,000, not including the corporate acquisition, which is 98 percent more than the $10,125,000 invested in 2004. The Saskatchewan drilling, completing, facilities and pipelines total expenditures were $0.5 million. In Alberta, Milagro drilled, completed and equipped nine oil wells and installed facilities and pipelines for a capital expenditure of $19.4 million. Corporate capital expenditures spent were $0.2 million. In 2005, Milagro reinvested 7.3 times (2004 – 2.8 times) its cash flow from operations.

## LIQUIDITY AND CAPITAL RESOURCES

| ($000s) | Three Months Ended Dec. 31, 2005 | 2004 | % Change | Year Ended Dec. 31, 2005 | 2004 | % Change |
|---|---|---|---|---|---|---|
| Cash flow from operations | **408** | 693 | (41) | **2,670** | 3,564 | (25) |
| Net proceeds from shares issued | **28** | 7 | (100) | **6,925** | 3,679 | 88 |
| Increase (decrease) in bank debt | **5,246** | 113 | 4,508 | **2,542** | 1,679 | 51 |
| Change in working capital | **4,832** | 2,473 | 95 | **4,505** | 1,144 | 294 |
| Abandonment & site restoration | **1** | (7) | (100) | **17** | (106) | 116 |
| Total funding | **10,515** | 3,279 | 221 | **16,659** | 9,960 | 67 |

At December 31, 2005, Milagro's net debt (working capital deficiency including bank debt) was $12,901,000, up from $5,702,000 at December 31, 2004. Milagro has established an $18 million demand revolving production loan with its principal lender, the terms of which are reviewed annually.

Milagro's 2005 capital expenditure program was funded 37 percent through the issuance of new equity, 41 percent from cash flow from operations and proceeds from dispositions and 22 percent from changes in working capital (including bank debt). During 2005, Milagro issued 5,751,760 common shares for gross proceeds of $7,370,743 as follows:

| | |
|---|---|
| Private placement of 2,000,000 flow-through common shares at $1.50 per share | $ 3,000,000 |
| Private placement of 1,131,500 flow-through common shares at $1.44 per share | 1,629,360 |
| Private placement of 2,143,000 common shares at $1.19 per share | 2,550,170 |
| Exercise of options to acquire 477,260 common shares | 191,213 |

Milagro had 53,531,406 common shares outstanding at December 31, 2005 – 11.5 percent held by officers and directors.

During 2005, 145,000 stock options were granted at an average exercise price of $1.17 per share, 477,260 stock options were exercised at an average price of $0.40 per share and 15,000 stock options were cancelled at an average $0.74 per share. At December 31, 2005, Milagro had 1,331,182 stock options outstanding with an average exercise price of $0.68 per share.

## CONTRACTUAL OBLIGATIONS

Milagro has identified the following contractual obligations:

Office space – Milagro has entered into a lease for its office premises through to December 30, 2006. The estimated amount to be paid annually under this lease is $81,000.

Asset Retirement Obligations – Milagro is the owner of oil and natural gas wells and related surface equipment and facilities. These assets will have to be abandoned and the surface returned to its natural state. At December 31, 2005, Milagro estimated its future asset retirement obligation to be $3,245,000 which is exclusive of salvage values. Milagro estimates that the salvage value of its field equipment would offset a significant portion of its estimated future asset retirement obligation. Milagro does not expect to incur significant asset retirement cost obligations within the next five years.

Flow-through Qualifying Expenditures – At December 31, 2005 Milagro had an obligation related to the issuance of flow-through common shares to incur approximately $4,629,360 of qualifying expenditures before December 31, 2006, and this obligation was completely filled by December 31, 2005.

## OUTSTANDING SHARE DATA

On March 3, 2006, Milagro had the following securities outstanding: 53,531,406 common shares and 1,214,516 stock options. On January 21, 2006 after the December 31, 2005 year end financial statements 116,666 stock options were cancelled.

## FINANCIAL INSTRUMENTS

Milagro does not have any financial instruments in place at this time.

## OFF-BALANCE SHEET ARRANGEMENTS

Milagro does not have any special purposes entities nor is it a party to any arrangement that would be excluded from the balance sheet.

## RELATED PARTY TRANSACTIONS

During 2005, Milagro entered into commercial business transactions with three related parties, all of whom are Milagro directors. One of the related parties is a partner of a law firm that provides legal services to Milagro, one is a significant shareholder and the President of a corporation that provides well logging and perforating services to Milagro, and the third is the President of a corporation that provides pipeline construction services to Milagro. The following table summarizes the payments made by Milagro to these three entities during the last three months and the twelve months of 2005 and 2004.

| | Three months ended Dec 31, | | Twelve months ended Dec 31, | |
|---|---|---|---|---|
| | **2005** | 2004 | **2005** | 2004 |
| Legal fees | $ 68,100 | $ 12,291 | $156,561 | $ 76,153 |
| Well logging and perforating services | $247,748 | $ 37,287 | $307,875 | $124,397 |
| Pipeline construction services | $567,100 | – | $567,100 | – |

Of the total $156,561 in legal fees paid during the twelve months ended December 31, 2005, $62,356 (2004 – $67,227) was charged to general and administrative expenses, $38,364 (2004 – $8,926) was charged to share issue costs, and $15,898 (2004 – NIL) was charged to property and equipment, and $39,943 (2004 – NIL) has been charged to deferred acquisition costs. All of the $307,875 (2004 – $124,397) in well logging and perforating services paid during the twelve months ended December 31, 2005 was charged to property and equipment. All of the $567,100 (2004 – NIL) in pipeline construction costs paid during the twelve months ended December 31, 2005 was charged to property and equipment.

### Application of Critical Accounting Estimates

The significant accounting policies used by Milagro are disclosed in note 1 to the Financial Statements. Certain accounting policies require that management make appropriate decisions with respect to the formulation of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Management reviews its estimates on a regular basis. The emergence of new information and changed circumstance may result in actual results or changes to estimated amounts that differ materially from current estimates. The following discussion helps to assess the critical accounting policies and practices of the Company and the likelihood of materially different results being reported.

### Proved Reserves

Under National Instrument 51-101 "Proved" reserves are defined as those reserves that can be estimated with a high degree of certainty to be recoverable. The level of certainty should result in at least a 90 percent probability that the quantities actually recovered will equal or exceed the estimated Proved reserves. It does not mean that there is a 90 percent probability that the Proved reserves will be recovered – it means there must be at least a 90 percent probability that the given amount or more will be recovered.

"Proved plus Probable" reserves are the most likely case and are based on a 50 percent certainty that they will equal or exceed the reserves estimated. The standard provides for a conservative evaluation of proved and probable reserves, particularly on new wells where production history has not yet been established.

These oil and gas reserve estimates are made using all available geological and reservoir data, as well as historical production data. Estimates are reviewed on a quarterly basis and revised as appropriate. Revisions occur as a result of various factors including: actual reservoir performance, changes in price and cost forecasts or a change in the Company's plans. Reserve changes will impact the financial results as reserves are used in the calculation of depletion and are used to assess whether asset impairment occurs. Reserve changes also affect other Non-GAAP measurements such as finding and development costs, recycle ratios and net asset value calculations.

### Depletion

The Company follows the full cost method of accounting for oil and natural gas properties. Under this method, all costs related to the acquisition of, exploration for and development of oil and natural gas reserves are capitalized whether successful or not. Depletion of the capitalized oil and natural gas properties and depreciation of production equipment which includes estimated future development costs less estimated salvage values are calculated using the unit of production method, based on production volumes in relation to estimated proven reserves.

An increase in estimated proved reserves would result in a reduction in depletion expense. A decrease in estimated future development costs would also result in a reduction in depletion expense.

### Unproved Properties

The cost of acquisition and evaluation of unproved properties are initially excluded from the depletion calculation. These properties are assessed to ascertain whether impairment in value has occurred. When proved reserves are assigned or a property is considered to be impaired, the cost of the property or the amount of the impairment will be added to the capitalized costs for the calculation of depletion.

### Ceiling Test

The carrying value of property, plant and equipment is reviewed for impairment. Impairment is determined by the carrying amount of the property, plant and equipment exceeding the sum of the undiscounted cash flows expected to result from the Company's proved reserves. Cash flows are calculated based on third party quoted forward prices and adjusted for the Company's contract prices and quality differentials. If there is impairment, the magnitude of it would be calculated by comparing the carrying amount of property, plant and equipment to the estimated net present value of future cash flows from proved plus probable reserves. A risk-free interest rate is used to arrive at the net present value of the future cash flows. Any excess carrying value above the net present value of future cash flows would be recorded as a permanent impairment and charged as additional depletion expense in the Statement of Operations.

### Asset Retirement Obligation

The Company recognizes the fair value of an asset retirement obligation ("ARO") in the period in which it is incurred when a reasonable estimate of fair value can be made. The fair value of the estimated ARO is recorded as a long-term liability, with a corresponding increase in the carrying amount of the related asset. The capitalized amount is depleted on a unit-of-production basis over the life of the reserves. The liability amount is increased each reporting period due to the passage of time and the amount of this accretion is charged to earnings in the period. Revisions to the estimated timing of cash flows or to the original estimated undiscounted cost would also result in an increase or decrease to the ARO. Actual costs incurred upon settlement of the ARO are charged against the ARO to the extent of the liability recorded. Any difference between the actual cost incurred upon settlement of the ARO and the recorded liability is recognized as a gain or loss in the Company's earnings in the period in which the settlement occurs.

Determination of the original undiscounted costs are based on engineering estimates using current costs and technology in accordance with existing legislation and industry practice. The estimation of these costs can be affected by factors such as the number of wells drilled, well depth and area-specific environmental legislation.

### Income Taxes

The determination of income and other tax liabilities requires interpretation of complex laws and regulations. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ significantly from the amount estimated amount recorded by management.

## DISCLOSURE CONTROLS AND PROCEDURES

As at December 31, 2005 an evaluation was carried out under the supervision of and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective as at December 31, 2005 to provide reasonable assurance that the material information relating to the Company would be made known to them by others within the company.

## CHANGES IN ACCOUNTING POLICIES

The company had no significant changes in accounting policies in 2005.

## DATE

This Management's Discussion and Analysis is dated March 3, 2006.

## ADDITIONAL INFORMATION

Additional information regarding Milagro, including the Annual Information Form for the year ended December 31, 2005, is available on SEDAR at www.sedar.com.

## RISKS AND UNCERTAINTIES

The business of exploring for, developing and producing oil and natural gas reserves is inherently risky. There is substantial risk that the manpower and capital employed will not result in the finding of new reserves in economic quantities. There is a risk that the sale of reserves may be delayed indefinitely due to processing constraints, lack of pipeline capacity or lack of markets. The price Milagro receives for its oil and natural gas production fluctuates continuously and, for the most part, is beyond the Company's control. Milagro is exposed to financial risks including fluctuation in interest rates and the Canadian/US dollar exchange rate. Milagro is also subject to the risks associated with owning oil and natural gas properties, including environmental risks associated with air, land and water. In all areas of our business, we compete against entities that may have greater technical and financial resources. Milagro's growth is dependent upon external sources of financing which may not be available on acceptable terms. There are numerous uncertainties in estimating Milagro's reserve base due to the complexities in estimating the magnitude and timing of future production, revenue, expenses and capital.

Milagro mitigates these risks by hiring highly qualified personnel, either directly as employees or indirectly when contracting for services. Our philosophy of focusing on a limited number of geographical areas allows us to develop a high level of technical and managerial expertise in each area. To control the cost and pace of development, we acquire high working interests in each prospect and operate wherever possible. Milagro may enter into commodity price and interest rate hedging strategies to add a degree of certainty to cash flow. We diversify our oil and natural gas marketing by using various marketers and a variety of contracts with respect to pricing and term. In the field, we adhere to sound operational standards, which meet or exceed recognized levels. Finally, Milagro maintains an insurance program consistent with industry practice to protect against destruction of assets, well blowouts, pollution and other business interruptions.

## SUMMARY OF QUARTERLY RESULTS

| | 2005 | | | | 2004 | | | |
|---|---|---|---|---|---|---|---|---|
| | Q4 | Q3 | Q2 | Q1 | Q4 | Q3 | Q2 | Q1 |
| **Financial Highlights** | | | | | | | | |
| ($000s, except per share amounts) | | | | | | | | |
| Oil and gas revenue | 2,386 | 2,385 | 1,696 | 1,894 | 1,987 | 2,491 | 2,297 | 2,430 |
| Cash flow from operations | 408 | 1,002 | 598 | 661 | 693 | 1,051 | 892 | 928 |
| Per share – basic | 0.01 | 0.02 | 0.01 | 0.01 | 0.01 | 0.02 | 0.02 | 0.02 |
| Per share – diluted | 0.01 | 0.02 | 0.01 | 0.01 | 0.01 | 0.02 | 0.02 | 0.02 |
| Net earnings (loss) | (431) | (274) | 737 | (136) | (2029) | (16) | (170) | (284) |
| Per share – basic | (0.01) | (0.01) | 0.02 | – | (0.04) | – | – | (0.01) |
| Per share – diluted | (0.01) | (0.01) | 0.02 | – | (0.04) | – | – | (0.01) |
| Capital expenditures | 12,476 | 4,583 | 3,166 | (3,648) | 3.279 | 2,090 | 1,309 | 3,282 |
| Debt and working capital | 12,901 | 2,862 | 3,798 | 1,253 | 5,702 | 3,117 | 2,063 | 5,253 |
| Shareholders' equity | 30,075 | 30,445 | 23,776 | 22,986 | 24,280 | 26,289 | 26,297 | 22,774 |
| Total assets | 49,375 | 40,232 | 32,564 | 29,918 | 34,152 | 34,750 | 33,501 | 33,470 |
| **Operating Highlights** | | | | | | | | |
| Average daily production volumes | | | | | | | | |
| Oil and NGLs (bbl/day) | 339 | 329 | 305 | 388 | 427 | 457 | 440 | 522 |
| Natural gas (mcf/day) | 828 | 770 | 831 | 940 | 1,044 | 1,383 | 1,402 | 1,510 |
| BOE (BOE/day) | 477 | 457 | 443 | 545 | 601 | 687 | 673 | 774 |
| Field netbacks – oil and NGLs ($/bbl) | | | | | | | | |
| Selling price | 49.05 | 57.69 | 41.16 | 38.13 | 34.78 | 40.62 | 35.54 | 32.97 |
| Royalties | (7.75) | (8.85) | (6.90) | (5.46) | (4.92) | (10.28) | (5.92) | (8.48) |
| Production expenses | (22.55) | (19.88) | (15.70) | (12.08) | (9.79) | (7.44) | (7.23) | (7.00) |
| Transportation | (2.09) | (1.74) | (1.04) | (2.48) | (1.72) | (1.98) | (2.29) | (2.18) |
| Field netback | 16.66 | 27.22 | 17.52 | 18.11 | 18.35 | 20.92 | 20.10 | 15.31 |
| Field netbacks – natural gas ($/mcf) | | | | | | | | |
| Selling price | 11.23 | 9.01 | 7.32 | 6.67 | 6.45 | 6.16 | 6.86 | 6.29 |
| Royalties | (0.59) | (0.84) | (0.60) | (0.57) | (0.60) | (0.85) | (0.70) | (0.96) |
| Production expenses | (6.57) | (3.30) | (2.04) | (2.41) | (2.33) | (1.79) | (1.63) | (1.55) |
| Transportation | (0.22) | (0.18) | (0.18) | (0.17) | (0.20) | (0.18) | (0.18) | (0.22) |
| Field netback | 3.85 | 4.69 | 4.49 | 3.52 | 3.32 | 3.34 | 4.35 | 3.55 |
| Field netbacks – equivalent unit ($/BOE) | | | | | | | | |
| Selling price | 54.34 | 56.70 | 42.02 | 38.67 | 35.91 | 39.39 | 37.49 | 34.52 |
| Royalties | (6.53) | (7.80) | (5.87) | (4.87) | (4.54) | (8.54) | (5.32) | (7.60) |
| Production expenses | (27.43) | (19.86) | (14.63) | (12.76) | (11.01) | (8.54) | (8.12) | (7.76) |
| Transportation | (1.87) | (1.57) | (1.05) | (2.06) | (1.57) | (1.68) | (1.87) | (1.91) |
| Field netback | 18.51 | 27.47 | 20.47 | 18.98 | 18.79 | 20.63 | 22.18 | 17.25 |
| Corporate cash netbacks ($/BOE) | | | | | | | | |
| Field netback | 18.51 | 27.48 | 20.47 | 18.98 | 18.79 | 20.63 | 22.18 | 17.25 |
| General and administrative expenses | (6.65) | (2.23) | (3.88) | (4.39) | (4.43) | (2.34) | (5.66) | (2.83) |
| Financing charges | (1.70) | (0.14) | (0.59) | (0.62) | (0.84) | (0.75) | (1.15) | (0.35) |
| Current income and other taxes | (0.87) | (1.27) | (1.17) | (0.49) | (0.99) | (0.92) | (0.82) | (0.89) |
| Cash flow from operations | 9.29 | 23.84 | 14.83 | 13.48 | 12.53 | 16.62 | 14.55 | 13.18 |
| **Common Share Information** | | | | | | | | |
| Shares outstanding (000s) | | | | | | | | |
| Weighted average during the period | 53,488 | 52,318 | 48,155 | 48,077 | 47,780 | 47,780 | 41,568 | 41,497 |
| Period end – basic | 53,531 | 53,473 | 48,161 | 48,131 | 47,780 | 47,780 | 47,780 | 41,499 |
| Period end – fully diluted | 54,863 | 54,862 | 49,488 | 49,458 | 49,458 | 48,883 | 49,133 | 42,969 |

# Financial Statements and Notes

## MANAGEMENT'S REPORT TO THE SHAREHOLDERS

All of the information in this annual report is the responsibility of management. The accompanying financial statements of Milagro Energy Inc. have been prepared by management in accordance with Canadian generally accepted accounting principles. The financial information elsewhere in the annual report has been reviewed to ensure consistency in all material respects with that in the financial statements.

Milagro Energy Inc. maintains appropriate systems of internal control to give reasonable assurance that transactions are appropriately authorized, assets are safeguarded from loss or unauthorized use and financial records provide reliable and accurate information for the preparation of financial statements.

Collins Barrow Calgary LLP, an independent firm of Chartered Accountants, have been engaged to examine the financial statements and provide their Auditors' Report. Their report is presented with the financial statements. The Directors are responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Directors exercise this responsibility through the Audit Committee. This Committee, which is comprised of non-management Directors, meets with management and the external auditors to satisfy itself that management responsibilities are properly discharged and to review the financial statements before they are presented to the Directors for approval. The financial statements have been approved by the Board of Directors on the recommendation of the Audit Committee.

Jeffrey C. Rekunyk
President and CEO

R. Brad Haack
VP Finance and CFO

## AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Milagro Energy Inc. as at December 31, 2005 and 2004 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Collins Barrow Calgary LLP
Chartered Accountants
Calgary, Alberta
March 3, 2006

## CONSOLIDATED BALANCE SHEETS

| As at December 31 | **2005** | 2004 |
|---|---|---|
| **Assets** | | |
| Current assets | | |
| Cash | $ 39,303 | $ – |
| Accounts receivable | 1,281,770 | 702,716 |
| | 1,321,073 | 702,716 |
| Deferred acquisition costs (Note 4) | 42,364 | – |
| Property, plant and equipment (Note 5) | 48,011,895 | 33,449,393 |
| | $ 49,375,332 | $ 34,152,109 |
| **Liabilities** | | |
| Current liabilities | | |
| Accounts payable and accrued liabilities | $ 8,351,390 | $ 3,170,472 |
| Bank debt (Note 6) | 5,870,687 | 3,234,164 |
| | 14,222,077 | 6,404,636 |
| Future income taxes (Note 7) | 3,534,800 | 2,295,000 |
| Asset retirement obligations (Note 8) | 1,543,227 | 1,172,005 |
| | 19,300,104 | 9,871,641 |
| **Shareholders' equity** | | |
| Share capital (Note 9) | 31,332,944 | 25,564,487 |
| Contributed surplus | 193,000 | 63,300 |
| Deficit | (1,450,716) | (1,347,319) |
| | 30,075,228 | 24,280,468 |
| | $ 49,375,332 | $ 34,152,109 |

See accompanying notes.

On behalf of the Board of Directors

Jeffrey C. Rekunyk
Director

Robert J. Robertshaw
Director

## CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

| Years ended December 31 | **2005** | 2004 |
|---|---|---|
| **Revenues** | | |
| Oil and natural gas sales | **$ 8,361,025** | $ 9,205,279 |
| Royalties | **(1,089,249)** | (1,652,385) |
| | **7,271,776** | 7,552,894 |
| **Expenses** | | |
| Production | **3,257,697** | 2,192,672 |
| Transportation | **291,981** | 441,821 |
| General and administrative | **755,576** | 939,178 |
| Financing charges | **134,522** | 189,288 |
| Depletion, depreciation and accretion | **3,579,601** | 7,096,000 |
| Stock-based compensation (Note 9) | **129,700** | 38,300 |
| | **8,149,077** | 10,897,259 |
| **Loss before taxes** | **(877,301)** | (3,344,365) |
| **Taxes** (Note 7) | | |
| Capital taxes | **162,335** | 226,045 |
| Future income tax recovery | **(936,239)** | (1,071,000) |
| | **(773,904)** | (844,955) |
| **Net loss** | **(103,397)** | (2,499,410) |
| Retained earnings (deficit), beginning of year | **(1,347,319)** | 1,152,091 |
| Deficit, end of year | **$ (1,450,716)** | $ (1,347,319) |
| **Net loss per share** (Note 11) | | |
| Basic | **$ (0.00)** | $ (0.06) |
| Diluted | **$ (0.00)** | $ (0.06) |

See accompanying notes.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

| Years ended December 31 | 2005 | 2004 |
|---|---|---|
| **Cash provided by (used for):** | | |
| **Operations** | | |
| Net loss | $ (103,397) | $ (2,499,410) |
| Items not affecting cash | | |
| Depletion, depreciation and accretion of asset retirement obligations | 3,579,601 | 7,096,000 |
| Future income tax recoveries | (936,239) | (1,071,000) |
| Stock-based compensation | 129,700 | 38,300 |
| | 2,669,665 | 3,563,890 |
| Net change in non-cash working capital (Note 10) | 4,504,606 | 1,144,206 |
| Abandonment costs | 16,603 | (105,995) |
| | 7,190,874 | 4,602,101 |
| **Financing** | | |
| Issue of common shares | 7,370,743 | 3,775,207 |
| Increase in bank debt | 2,541,933 | 1,678,585 |
| Share issue costs | (445,247) | (95,882) |
| | 9,467,429 | 5,537,910 |
| **Investing** | | |
| Expenditures on property, plant, and equipment | (20,096,332) | (10,124,911) |
| Net cash paid on business combination (Note 3) | (2,060,616) | – |
| Expenditures on acquisition (Note 4) | (42,364) | – |
| Proceeds on sale of property and equipment | 5,580,312 | 164,900 |
| | (16,619,000) | (9,960,011) |
| **Change in cash** | $ 39,303 | $ – |
| **Cash, beginning of year** | – | – |
| **Cash, end of year** | $ 39,303 | $ – |

See accompanying notes.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
**For the Years Ended December 31, 2005 and 2004**

Milagro Energy Inc. (the "Company") is a public company incorporated under the Business Corporations Act (Alberta) engaged in the acquisition, exploration, development and production of petroleum and natural gas reserves in western Canada.

### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### (a) Principles of Consolidation

The consolidated financial statements include the accounts of the Company and, since September 20, 2005 (Note 3), its wholly owned subsidiary Tri-Seven Resources Ltd. ("Tri-Seven"). Tri-Seven and the Company were amalgamated on January 1, 2006.

#### (b) Oil and Natural Gas Operations

Capitalized Costs

The Company follows the full cost method of accounting for oil and natural gas operations, whereby all costs of acquiring, exploring for and developing oil and natural gas reserves, are capitalized and accumulated in one cost centre. Such costs include those related to lease acquisition, geological and geophysical activities, rentals on non-producing mineral leases, drilling of productive and non-productive wells, tangible production equipment, and that portion of general and administrative expenses directly attributable to exploration and development activities. Proceeds from the disposition of oil and natural gas properties or undeveloped properties are accounted for as a reduction of capitalized costs, with no gain or loss recognized unless such disposition would alter the depletion and depreciation rate by 20 percent or more.

Depletion and Depreciation

Depletion and depreciation of oil and natural gas properties is calculated using the unit-of-production method based on production volumes, before royalties, in relation to total proved hydrocarbon reserves as estimated by independent engineers. Natural gas volumes are converted to equivalent oil volumes based upon a relative energy content of six thousand cubic feet of natural gas to one barrel of oil. In determining costs subject to depletion, the Company includes estimated future costs to be incurred in developing proved reserves and excludes estimated salvage values. The cost of undeveloped properties are excluded from costs subject to depletion until it is determined that proved reserves are attributable to the property or impairment has occurred.

Ceiling Test

Oil and natural gas properties are evaluated at least annually to determine whether the carrying amount of the oil and natural gas properties is recoverable and that it does not exceed the fair value of the oil and natural gas properties. The carrying amounts are assessed to be recoverable when the sum of the undiscounted cash flows expected from the production of proved reserves plus the lower of cost and market of unproved properties exceeds the carrying amount of the oil and natural gas properties. When the carrying amount is not assessed to be recoverable, an impairment is recognized to the extent that the carrying amount of the oil and natural gas properties exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost and market of unproved properties that contain no probable reserves. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate. Any impairment is recorded as additional depletion and depreciation expense.

Asset Retirement Obligations

Asset retirement obligations include the abandonment of oil and natural gas wells, dismantling and removing tangible equipment such as oil batteries and natural gas facilities, and returning the land to its original condition. The Company recognizes an asset retirement obligation ("ARO") in the period in which it is identified and a reasonable estimate of the fair value can be made. Fair value is estimated based on the present value of the estimated future cash outflows to abandon the asset, discounted at the Company's credit-adjusted risk-free interest rate. The fair value of the estimated ARO is recorded as a long-term liability with a corresponding amount capitalized to oil and natural gas properties. The amount capitalized is charged to earnings through the depletion and depreciation of oil and gas properties. The ARO liability is increased each reporting period due to the passage of time and the amount of accretion is charged to earnings. Revisions to the original estimated cost or the timing of the cash outflows may result in a change to the ARO. Actual costs incurred to settle an ARO reduce the long-term liability.

Joint Ventures

Some of the Company's exploration and production activities are conducted jointly with other companies. These financial statements reflect only the Company's proportionate interest in such activities.

### (c) Depreciation

Depreciation of office equipment is provided for on a declining balance basis at a rate of 20 percent per annum.

### (d) Future Income Taxes

The Company uses the liability method of accounting for income taxes. Under this method, income tax assets and liabilities are recorded to recognize future income tax inflows and outflows arising from the recovery or settlement of assets and liabilities at carrying values. Income tax assets are also recognized for the benefits from tax losses and deductions that cannot be identified with particular assets or liabilities, provided those benefits are more likely than not to be realized. Future income tax assets and liabilities are determined based on the tax laws and rates that are anticipated to apply in the period of realization.

### (e) Flow-through Shares

The resource expenditure deductions for income tax purposes related to exploration and development activities funded by flow-through share arrangements are renounced to subscribers. To recognize the foregone tax benefits to the Company, share capital is reduced and a future tax liability is recorded equal to the estimated amount of future income taxes payable, when the income tax deductions are renounced.

### (f) Revenue Recognition

Revenue from the sale of oil and natural gas is recognized based on volumes delivered to customers at contractual delivery points and rates. The costs associated with the delivery, including operating and maintenance costs, transportation, and production-based royalty expenses are recognized in the same period in which the related revenue is earned and recorded.

### (g) Stock-based Compensation

The Company records stock-based compensation expense for stock options granted to employees, officers, directors and consultants after December 31, 2002 using the fair value method. Under this method, stock-based compensation expense is recorded over the vesting period of the option, based on the fair value of the option on the date of grant. The fair value of each option granted is estimated using the Black-Scholes option pricing model that takes into account, on the date of grant: the exercise price and expected life of the option; the price of the underlying security; the expected volatility and dividends (if any) on the underlying security; and the risk-free interest rate.

Stock-based compensation expense is recorded with a corresponding increase in contributed surplus. Consideration received on the exercise of an option, together with the amount previously charged to contributed surplus, is recorded as an increase in share capital. The Company has not incorporated an estimated forfeiture rate for stock options that will vest, but accounts for actual forfeitures as they occur.

### (h) Per Share Amounts

Basic net earnings (loss) per common share is computed by dividing net earnings (loss) by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed using the treasury stock method, whereby the effect of in-the-money instruments such as stock options or common share purchase warrants affect the calculation. The treasury stock method assumes that proceeds received from the exercise of in-the-money dilutive instruments plus the unamortized portion of stock-based compensation are used to repurchase common shares at the average market price during the period.

### (i) Measurement Uncertainty

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingencies. Such estimates primarily relate to unsettled transactions and events at the balance sheet date. Actual results could differ from those estimated.

The amount recorded for depletion and depreciation of oil and natural gas properties, the provision for asset retirement obligation costs and the ceiling test and impairment calculations are based on estimates of proved and probable reserves, production rates, commodity prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be significant.

The amounts disclosed related to fair values of stock options issued, and the resultant income (loss) and pro forma income (loss) effects are based on estimates of future volatility of the Company's share price, expected lives of the options, expected dividends to be paid by the Company and other relevant assumptions. Stock options granted under the Company's stock option plan are not transferable, cannot be traded and vest over a three-year period. By their nature, these estimates are subject to measurement uncertainty and the effect of changes in such estimates on the consolidated financial statements for future periods could be significant.

## 2. CHANGES IN ACCOUNTING POLICIES

### (a) Transportation Costs

In 2004 the Company adopted the amendment to CICA Handbook Section 1100, Generally Accepted Accounting Principles, whereby transportation costs are presented as an expense in the Statement of Operations and Deficit. Prior to 2004, transportation costs were recorded as a reduction of revenue.

### (b) Flow-through Shares

In 2004 the Company adopted the new accounting treatment recommended by the CICA Emerging Issues Committee in EIC 146, Flow-Through Shares. Under the new method of accounting, a future income tax liability is not recognized until the income tax deductions are renounced.

## 3. BUSINESS COMBINATION

On September 20, 2005, Milagro acquired all of the outstanding common shares of Tri-Seven for total consideration of $2,210,000 less working capital adjustments. Tri-Seven was a private oil and natural gas exploration and production company active in the Western Canadian sedimentary basin. The acquisition has been accounted for using the purchase method with the allocation of the purchase price as follows:

| | |
|---|---|
| **Net assets acquired and liabilities assumed** | |
| Property, plant and equipment | $ 3,345,464 |
| Working capital deficiency | (97,258) |
| Bank debt | (94,590) |
| Asset retirement obligations | (74,000) |
| Future income taxes | (1,019,000) |
| | $ 2,060,616 |
| **Consideration** | |
| Acquisition costs | 42,464 |
| Cash | 2,018,152 |
| | $ 2,060,616 |

## 4. DEFERRED ACQUISITION COSTS

Deferred acquisition costs of $42,364 relate to costs incurred related to Milagro's offer to purchase Chirripo Resources Inc. ("Chirripo") (Note 15). These costs include due diligence and legal fees. Upon closing of the acquisition, these costs will form part of the acquisition price of Chirripo.

## 5. PROPERTY, PLANT AND EQUIPMENT

| | **2005** | 2004 |
|---|---|---|
| Oil and natural gas properties | **$ 63,117,991** | $ 45,069,514 |
| Office equipment | **150,010** | 148,385 |
| | **63,268,001** | 45,217,899 |
| Less: accumulated depletion and depreciation | **(15,256,106)** | (11,768,506) |
| | **$ 48,011,895** | $ 33,449,393 |

At December 31, 2005, undeveloped property costs of $1,870,000 (2004 – $1,785,000) were excluded from the depletion and depreciation calculation.

During 2005, the Company capitalized $125,098 (2004 – $124,523) of general and administrative expenses relating to exploration and development activities.

At December 31, 2004 the cost ceiling of the Company's oil and natural gas properties based on prices described above and calculated as described in note 1(b) was $2,600,000 less than capitalized costs of those properties. As a result, the carrying value of the oil and natural gas properties was written down by $2,600,000 resulting in a recovery of future income taxes of $1,004,000, for a net affect on income of $1,596,000.

The benchmark oil and natural gas selling prices used in the December 31, 2005 ceiling test calculation are as follows:

| | Oil | | Natural Gas | |
|---|---|---|---|---|
| | Light Sweet Edmonton ($Cdn/bbl) | Company Average ($Cdn/bbl) | AECO-C Spot ($Cdn/mmbtu) | Company Average ($Cdn/mcf) |
| 2006 | 67.16 | 52.31 | 10.04 | 9.83 |
| 2007 | 65.26 | 54.60 | 9.38 | 9.22 |
| 2008 | 60.78 | 52.71 | 8.33 | 8.18 |
| 2009 | 59.80 | 52.61 | 7.73 | 7.56 |
| 2010 | 60.99 | 54.06 | 7.05 | 6.86 |
| 2011 | 62.21 | 55.50 | 6.89 | 6.65 |
| 2012 | 63.46 | 56.83 | 7.01 | 6.78 |
| 2013 | 64.73 | 58.11 | 7.14 | 6.94 |
| 2014 | 66.02 | 59.37 | 7.27 | 7.08 |
| 2015 | 67.34 | 61.13 | 7.40 | 7.21 |
| 2016 | 68.69 | 62.73 | 7.53 | 7.36 |
| 2017 | 70.06 | 64.20 | 7.68 | 7.50 |
| 2018 | 71.46 | 65.49 | 7.83 | 7.66 |
| 2019 | 72.89 | 66.78 | 7.99 | 7.81 |
| 2020 | 74.35 | 68.34 | 8.15 | 7.97 |

The prices increase at a rate of 2.0 percent per year after 2020. Adjustments were made to the benchmark prices to reflect varied delivery points and quality differentials in the products delivered.

## 6. BANK DEBT

The Company has a revolving operating demand loan facility of $18 million (restricted to $13,500,000 until closing of Chirripo acquisition (Note 15)) bearing interest at a Canadian financial institution's prime rate plus 0.25 percent per annum. The revolving demand loan is secured by a general assignment of book debts and $50 million demand debenture that provides for a floating charge over all of the Company's present and future assets. Under the terms of this agreement, the Company is required to meet certain financial covenants.

## 7. INCOME TAXES

The provision for income tax differs from the result that would be obtained by applying the combined Canadian federal and provincial tax rate to loss before taxes. The principal reasons for this difference are as follows:

| | 2005 | 2004 |
|---|---|---|
| Corporate tax rate | **37.62%** | 38.62% |
| Expected income tax recovery | **$ (330,000)** | $ (1,291,600) |
| Difference resulting from: | | |
| Impact of change in tax rates | **207,400** | 126,500 |
| Non deductible Crown charges | **183,500** | 339,300 |
| Resource allowance | **(243,300)** | (156,300) |
| Alberta royalty tax deduction | **–** | (84,700) |
| Non taxable capital gains | **(583,100)** | – |
| Other | **(170,739)** | (4,200) |
| Tax provision | **$ (936,239)** | $ (1,071,000) |

The provision for capital taxes reflected in the statement of operations includes Federal large corporation tax and Saskatchewan capital taxes, which includes the Saskatchewan resource surcharge.

The following table sets forth the components of the Company's future income tax liability at December 31, 2005 and 2004.

| | 2005 | 2004 |
|---|---|---|
| Liability related to carrying amount of property and equipment and asset retirement obligations in excess of available tax deductions | **$ 3,856,800** | $ 2,616,000 |
| Benefit of undeducted share issuance costs | **(322,000)** | (321,000) |
| | **$ 3,534,800** | $ 2,295,000 |

Corporate tax returns are subject to audit and reassessment by Canada Revenue Agency. The results of any reassessments will be accounted for in the year in which they are determined.

## 8. ASSET RETIREMENT OBLIGATIONS

The following table presents the reconciliation of the beginning and ending aggregate carrying amount of the asset retirement obligations associated with the retirement of oil and natural gas properties:

| | 2005 | 2004 |
|---|---|---|
| Balance, beginning of year | **$ 1,172,005** | $ 1,044,000 |
| Liabilities incurred | **188,619** | 150,000 |
| Liabilities assumed on business combination (Note 3) | **74,000** | – |
| Liabilities settled | **16,603** | (105,995) |
| Accretion expense | **92,000** | 84,000 |
| Balance, end of year | **$ 1,543,227** | $ 1,172,005 |

Total estimated future asset retirement costs of $3,245,000 (2004 – $2,564,000) have been discounted using an average credit-adjusted risk-free rate of 6 percent. Most of these obligations are not expected to be paid for several years and will be funded from general Company resources at the time of abandonment.

## 9. SHARE CAPITAL

### a) Authorized

Unlimited number of common shares, no par value

Unlimited number of preferred shares, issuable in series

### b) Common Shares Issued

| | Number of Shares | Stated Value |
|---|---|---|
| Balance, December 31, 2003 | 41,465,468 | $ 21,849,162 |
| Private placement of flow-through shares | 6,280,844 | 3,751,540 |
| Exercise of stock options | 33,334 | 23,667 |
| Share issue costs, net of future income taxes of $36,000 | – | (59,882) |
| Balance, December 31, 2004 | 47,779,646 | $ 25,564,487 |
| **Private placement of shares** | **5,274,500** | **7,179,530** |
| **Exercise of stock options** | **477,260** | **191,213** |
| **Tax benefit renounced to shareholders** | **–** | **(1,313,039)** |
| **Share issue costs, net of future income taxes of $156,000** | **–** | **(289,247)** |
| **Balance, December 31, 2005** | **53,531,406** | **$31,332,944** |

### c) Share Capital Offerings

In June 2004, the Company completed a private placement of 3,423,193 flow-through common shares priced at $0.57 per share and 2,857,651 flow-through common shares priced at $0.63 per share, for total proceeds of $3,751,540. Income tax deductions of $3,751,540 were renounced to subscribers effective December 31, 2004. Qualified expenditures of approximately $640,000 relating to the December 31, 2004 renunciation were incurred in 2005.

In July 2005, the Company completed a private placement of 2,000,000 Canadian Exploration Expense flow-through common shares, 1,131,500 Canadian Development Expense flow-through common shares, and 2,143,000 common shares at a price of $1.50, $1.44, and $1.19 per share, respectively. Completion of the private placement resulted in the issuance of 5,274,500 common shares for total gross proceeds of $7,179,530. Milagro had an obligation related to the issuance of flow-through common shares in 2005, to incur $4,629,360 of qualifying expenditures before December 31, 2006, and this obligation was completely filled by December 31, 2005.

### d) Stock-based Compensation

The Company has a stock option plan that provides for the issuance of options to employees, officers, directors and consultants. Under the plan, the exercise price of options granted cannot be less than the closing market price on the day immediately preceding the date of grant. Options typically vest over a three-year period and expire five years from the date of grant. The aggregate number of shares to be issued upon exercise of all options granted under the plan may not exceed the maximum number of shares permitted under the rules of any stock exchange on which the Company's common shares are listed. As at December 31, 2005, there were 1,308,224 common shares reserved for future issuance under the plan.

A summary of the Company's stock option plan as at December 31, 2005 and 2004 and changes during the years then ended is set forth below.

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | **Number of Options** | **Weighted-Average Exercise Price** | Number of Options | Weighted-Average Exercise Price |
| Outstanding, beginning of year | **1,678,442** | **$0.56** | 1,203,442 | $0.62 |
| Granted | **145,000** | **$1.17** | 925,000 | $0.57 |
| Exercised | **(477,260)** | **$0.40** | (33,334) | $0.71 |
| Cancelled | **(15,000)** | **$0.74** | (416,666) | $0.74 |
| Outstanding, end of year | **1,331,182** | **$0.68** | 1,678,442 | $0.56 |
| Exercisable at year end | **519,516** | **$0.62** | 615,109 | $0.48 |

Subsequent to year end, 116,666 stock options were cancelled.

The following table summarizes stock options outstanding at December 31, 2005.

| Weighted Average Exercise Prices | Options Outstanding | Weighted Average Remaining Contractual Life | Options Exercisable |
|---|---|---|---|
| $0.48 | 481,182 | 3.1 | 214,516 |
| $0.67 | 630,000 | 3.5 | 280,000 |
| $1.18 | 220,000 | 4.0 | 25,000 |
| $0.68 | 1,331,182 | 3.4 | 519,516 |

Stock options granted during 2004 and during 2005 are accounted for using the fair value method. The Company recorded stock-based compensation expense of $129,700 in 2005 (2004 – $38,300).

The fair value of each option granted was estimated on the date of grant using the Black-Scholes options pricing model with the following weighted average assumptions:

| Year of grant | **2005** | 2004 |
|---|---|---|
| Fair value of options granted ($/share) | **0.63** | 0.29 |
| Risk-free interest rate (%) | **3.46** | 3.8 |
| Expected life (years) | **4** | 4 |
| Expected volatility (%) | **68** | 61 |
| Expected dividend yield (%) | – | – |

Options granted to employees, officers and directors during 2002 are accounted for using the "intrinsic value method" whereby no compensation expense is recorded when the stock options are granted. If the fair value method was used to account for stock options granted to employees, officers and directors in 2002, the stock-based compensation costs and the pro forma net loss and pro forma net loss per share would be as follows:

| | 2004 |
|---|---|
| Stock-based compensation costs ($) | 26,000 |
| Net loss | |
| As reported ($) | (2,499,410) |
| Pro forma ($) | (2,525,410) |
| Loss per share – basic | |
| As reported ($ per share) | (0.06) |
| Pro forma ($ per share) | (0.06) |

## 10. SUPPLEMENTAL CASH FLOW INFORMATION

| | 2005 | 2004 |
|---|---|---|
| Changes in non-cash working capital: | | |
| Working capital deficiency assumed on business combination (Note 3) | $ (97,258) | $ – |
| Accounts receivable | (579,054) | 842,738 |
| Accounts payable and accrued liabilities | 5,180,918 | 301,468 |
| | $ 4,504,606 | $ 1,144,206 |
| Cash payments included in the statement of cash flows: | | |
| Capital taxes | $ 240,000 | $ 481,820 |
| Financing charges | $ 134,522 | $ 181,813 |

## 11. PER SHARE AMOUNTS

| | 2005 | 2004 |
|---|---|---|
| Loss per share: | | |
| Basic | $ (0.00) | $ (0.06) |
| Diluted | $ (0.00) | $ (0.06) |
| Weighted average number of shares outstanding: | | |
| Basic | 50,529,517 | 44,672,999 |
| Diluted | 50,529,517 | 44,672,999 |

The calculation of diluted loss per share for 2005 and 2004 does not include any stock options, as the inclusion of these options would have been anti-dilutive.

## 12. FINANCIAL INSTRUMENTS

Credit risk

A portion of the Company's accounts receivable are with joint venture partners in the oil and gas industry and are subject to normal industry credit risks. Purchasers of the Company's oil and natural gas production are subject to an internal credit review designed to minimize the risk of non-payment.

Fair values

The Company's financial instruments included on the balance sheets as at December 31, 2005 and 2004 are comprised of accounts receivable, accounts payable and accrued liabilities and bank debt. The fair values of these financial instruments approximate their carrying value due to the short-term nature of those instruments.

Interest rate risk

The Company is exposed to interest rate risk to the extent the changes in market interest rates will impact the Company's bank debt that has a floating interest rate.

## 13. RELATED PARTY TRANSACTIONS

A director of the Company is a partner of a law firm that provides legal services to the Company. During 2005, the Company paid a total of $156,561 (2004 – $76,153) to this firm for legal fees and disbursements, of which $49,241 is included in accounts payable and accrued liabilities at December 31, 2005 (2004 – $3,376). Of the total amount paid $38,364 (2004 – $8,926) has been included as share issue costs, $15,898 has been included in property, plant and equipment (2004 – NIL), $39,943 has been capitalized as deferred acquisition costs, and the remaining amount of $62,356 (2004 – $67,227) has been included as general and administrative expense.

A director of the Company is the President and significant shareholder of a corporation that provided services to the Company. During 2005, the Company paid a total of $307,875 (2004 – $124,397) for well logging and perforating services, which has been included in property and equipment. Of this amount, $14,059 is included in accounts payable and accrued liabilities at December 31, 2005 (2004 – $20,796).

A director of the Company is the President and significant shareholder of a corporation that has provided services to the Company. During 2005, the Company paid a total of $567,100 (2004 – NIL) for pipeline construction work, which has been included in property and equipment.

These transactions have been recorded at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

## 14. COMMITMENTS

The Company has a lease commitment for its office premises through to December 30, 2006. The amount due under this commitment, including rent and estimated operating expenses, is $81,000.

## 15. SUBSEQUENT EVENTS

Subsequent to the year end, the Company closed a takeover bid to acquire 100 percent (being 11,839,268 shares) of Chirripo Resources Inc. ("Chirripo") for $5,919,634 cash and 5,919,634 Milagro common shares. The Company will account for the acquisition of Chirripo as a business combination and the results of operations of Chirripo will be included in the results of the Company from the closing date.

## CORPORATE INFORMATION

### DIRECTORS

William C. Darling (1)(2)(3)
President, Big Guns Perforating and Logging Inc.

William C. Guinan (4)
Partner, Borden Ladner Gervais LLP

Robert J. Pritchard (1)(2)(3)
President, Taylor Gas Liquids Ltd.

Jeffrey C. Rekunyk (4)
President, Milagro Energy Inc.

Robert J. Robertshaw (1)(2)(3)(4)
President, Denim Pipeline Construction Ltd.

(1) Member of the Audit Committee
(2) Member of the Compensation Committee
(3) Member of the Reserves Committee
(4) Member of the Disclosure Committee

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### OFFICERS AND SENIOR MANAGEMENT

Jeffrey C. Rekunyk, BSc
President and CEO

R. Brad Haack, B.Comm
VP Finance and CFO

Aaron Lane, P. Eng
Operations Manager

### AUDITORS

Collins Barrow Calgary LLP
Calgary, Alberta

### RESERVES ENGINEERS

DeGolyer and MacNaughton Canada Limited
Calgary, Alberta

### BANKER

National Bank of Canada
Calgary, Alberta

### LEGAL COUNSEL

Borden Ladner Gervais LLP
Calgary, Alberta

### TRANSFER AGENT & REGISTRAR

Computershare Trust Company of Canada
Calgary, Alberta

### STOCK EXCHANGE LISTING

The TSX Exchange
Trading Symbol: MIG

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